



**STATE INVESTMENT BOARD
BOARD ADOPTED POLICIES**

POLICY NUMBER: 2.10.200

EFFECTIVE DATE: 4/18/02

TITLE: Fixed Income – Retirement Funds

SUPERSEDES: 3/30/01

BOARD ADOPTION: 4/18/02

APPROVED:

A handwritten signature in black ink, appearing to read "Brad Brubaker", written over a horizontal line.

PURPOSE:

This document outlines the investment policy and guidelines for the fixed income segment of the State Investment Board (SIB) Retirement Funds and supersedes any prior Board-adopted policies.

These guidelines allow for sufficient flexibility in the management process to capture investment opportunities, while providing parameters that ensure prudence and care in the execution of the fixed income investment program.

POLICY:

Standard of Care

Under RCW 43.33A.030, trusteeship of the state's retirement funds are vested in the voting members of the Board. The Legislature has established a standard of care for investment of these funds in RCW 43.33A.140. Additionally, the Board and its staff must comply with other state laws, such as the Ethics in Public Service Act, Chapter 42.52 RCW, as it makes its investment decisions and seeks to meet the investment objectives below.

Strategic Objectives

The fixed income segment is to be managed to:

- A. Achieve the highest return possible consistent with the desire to: (1) control asset volatility; and, (2) to emphasize high yield to maturity opportunities to add value through active management.
- B. Provide diversification to the SIB's overall investment program.

Performance Objective

The SIB's fixed income investments are to be actively managed to meet or exceed the return of the Lehman Aggregate Bond Index, with volatility similar to or less than the index.

Investment Approach

The investment approach shall be to identify enhanced yield opportunities across bond market segments and to invest where credit and reinvestment risks are understood and can be managed well within yield benefits.

The SIB will manage the four major categories of fixed income risk:

1. Interest Rate Risk
2. Yield Curve Risk
3. Credit Risk
4. Reinvestment Risk

Interest Rate Risk is price volatility produced by changes in the overall level of interest rates. This risk is to be managed in a controlled manner using historical real return relationships and economic analysis.

Yield Curve Risk is price changes induced by the changing slope of the yield curve. Yield curve risk is to be managed, but in a controlled, disciplined fashion, by employing duration and maturity yield spread analysis.

Credit Risk is the uncertainty surrounding the borrower's ability to repay its obligations. Credit risk is to be actively managed, employing yield spread analysis and credit research.

Reinvestment Risk is the uncertain future yield opportunities available to invest funds which become available due to call, maturity, or coupon generated cash flow. Reinvestment risk is to be managed through call risk analysis, and diversification of maturities.

Strategies

- A. The fixed income assets are to be managed to add value principally through credit, valuation and interest rate level analysis.
- B. Internal management is to be used unless special expertise is required, or a special opportunity exists, which can only be accessed by contracting with external managers.
- C. A two-tier macro/micro management approach is to be used to implement the portfolio strategies. The macro component is to include strategic and some tactical decision processes, such as the allocation among different fixed income segments. The micro

component will address security selection within each fixed income segment utilizing credit, duration, and valuation analysis.

- D. Value at the macro level is to be added through the allocation of cash flow to fixed income segments which offer the highest yield to maturity spreads relative to their historical norms. Within policy ranges, duration should be managed with cash flow by concentrating purchases along the yield curve where the yield premium is high relative to historical norms. When a fixed income segment exhibits a yield spread versus Treasuries greater than historical norms, new cash flow and/or the redeployment of existing assets shall be made to that segment.

Portfolio Constraints

- A. All assets under management by the SIB are to be invested to maximize return at a prudent level of risk (RCW 43.33A.110 and RCW 43.33A.140).
- B. No corporate fixed income issue's cost shall exceed three percent of the fund's market value at the time of purchase, nor shall its market value exceed six percent of the fund's market value at any time (RCW 43.33A.140).
- C. The par value of bonds from any one issuer with a below investment grade rating (rated Ba1 or below by Moody's Investors Service [Moody's]) shall not exceed one percent of the total portfolio's par value.
- D. Permissible Fixed Income Market Segments:
 - 1. *U.S. Treasuries and Government Agencies.*
 - 2. *Credit Bonds.*
 - 3. *Mortgage-Backed Securities* rated BBB- or higher by Standard & Poor's, or Baa3 or higher by Moody's.
 - 4. *Asset-Backed Securities* rated BBB - or higher by Standard & Poor's or Baa3 or higher by Moody's.
 - 5. *Commercial Mortgage-Backed Securities* rated BBB- or higher by Standard & Poor's or Baa3 or higher by Moody's.
 - 6. *Convertible Securities.*
 - 7. *Non-Dollar Bonds.*

8. Washington State Housing Finance Commission (HFC) taxable municipal bonds up to a total of \$50 million with a maximum of \$10 million purchased per year.

Other fixed income segments and instruments may be added from time to time as they are developed or deemed appropriate.

- E. Sector Allocations: Sector allocations are to be managed within the ranges presented below. These targets are long-term in nature. Deviations may occur in the short-term as a result of interim market conditions; however, if a range is exceeded, the portfolio must be rebalanced to the target allocations, as soon as it is practical.

Target Allocations for the Fixed Income Sectors:

	<u>Range</u>
U.S. Treasuries and Government Agencies	10 – 45%
Credit Bonds	10 – 60%
Asset-Backed Securities	0 – 10%
Commercial Mortgage-Backed Securities	0 – 10%
Mortgage-Backed Securities	5 – 45%
Total Bonds	100%

- F. Total holdings of below investment grade credit bonds (rated Ba1 or below by Moody's) should not exceed 15 percent of total bond holdings.
- G. Duration: The fixed income portfolio's duration is to be targeted within plus or minus 20 percent of the duration of the portfolio's performance benchmark, the Lehman Aggregate Index.

Reporting

- A. A management information system is to be used for reporting internally to senior staff on the implementation of this policy. This report is prepared monthly to include, but is not limited to:
 1. Current market value and allocations, by sector, compared to the index and the policy ranges;
 2. Aggregate and individual portfolio characteristics compared to guidelines; and,
 3. Delinquencies and defaults.
- B. An executive management report is to be provided to the Board quarterly showing market values and performance.

RESPONSIBILITIES:

State Investment Board - Responsible for approving the portfolio's strategic investment policy.

Public Markets Committee - Responsible for reviewing and recommending the strategic policy to the Board, and for reviewing the structure, strategy and performance of the portfolio.

Staff - Responsible for recommending an investment policy to the Public Markets Committee, for implementing the policy, and for reporting to the Public Markets Committee and the Board.

Original Policy Adopted 6/29/81
Revised 11/9/81
Revised 5/10/82
Revised 8/9/82
Revised 11/8/82
Revised 11/14/83
Revised 6/16/92; supersedes Policy 2.15.200
Revised 6/16/94
Revised 9/15/94
Revised 3/16/95
Revised 4/18/96
Revised 5/21/98
Revised 3/30/01 (Supersedes Policy 2.15.100, 5/21/98)
Revised 4/18/02